LPL RESEARCH
WEEKLY MARKET COMMENTARY

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BOTTOM LINE:
IMPRESSIVE EARNINGS SEASON

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KEY TAKEAWAYS

Corporate America has delivered double-digit earnings growth for the second consecutive quarter with solid upside to forecasts.

The breadth of earnings gains and magnitude of upside to revenue forecasts have been impressive, with generally upbeat management outlooks.

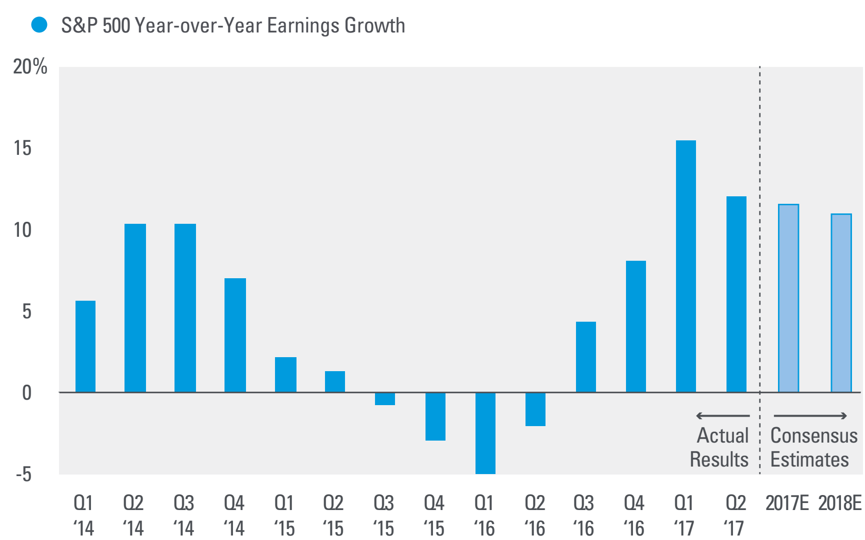
Strong earnings continue to provide support for the stock market even at elevated valuations.

Corporate America delivered another outstanding earnings season, with double-digit earnings growth, solid upside to forecasts, and generally upbeat outlooks from corporate management teams. We have been particularly impressed with the breadth of earnings gains and upside to revenue forecasts. Strong earnings continue to provide support for the stock market at elevated valuations, with the potential for more support from a reduced corporate tax rate next spring. Here we provide an overview of the nearly completed second quarter 2017 earnings season.

OUTSTANDING BOTTOM LINE

With about 90% of the S&P 500 Index companies having reported results, earnings growth is tracking to a 12% year-over-year increase, the second straight double-digit gain [Figure 1]. The earnings beat rate of 74% is nicely above the five-year average (68%). Although the 4% upside to June 30 estimates (12% versus 8%) is

1 BACK-TO-BACK DOUBLE-DIGIT GAINS



Source: LPL Research, Thomson Reuters, FactSet 08/11/17

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

only about 1% above the long-term average upside, we are impressed with this result coming off the strong first quarter. The breadth of the earnings gains is also notable, with energy, financials, and technology each contributing 18% or more to the overall increase in S&P 500 earnings [Figure 2].

The consistency with which companies have beaten estimates is also impressive, even when considering the historical pattern of consensus estimate reductions that give companies a lower bar. Earnings have beaten consensus estimates for 33 consecutive quarters, covering much of the current economic expansion (based on Thomson data).

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It is worth noting that the comparison for second quarter 2017 earnings growth against the year-ago quarter was easy, as it was in the first quarter. But it did get slightly tougher compared with the first quarter—growing off of a 5% decline in the first quarter of 2016 and a 2% decline in the second quarter of 2016. Comparisons will continue to toughen over the next several quarters, so earnings growth rates are likely to moderate further.

IMPRESSIVE REVENUE UPSIDE

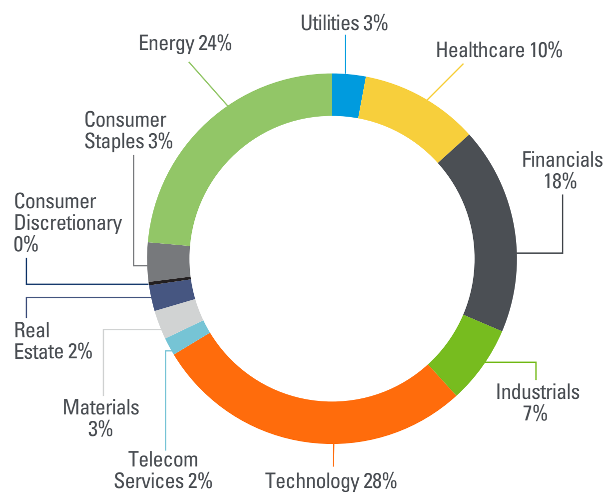
The revenue performance from corporate America is equally impressive. S&P 500 revenue growth is tracking to a 5.1% year-over-year increase, about 0.5% above June 30 estimates, as 68.5% of companies have exceeded revenue targets (versus the five-year average of 53% [Figure 3]). Revenue upside has been much tougher to come by in recent years, so these numbers are as good as we've seen in a while (since the second quarter of 2011).

CONSIDER THE SOURCE

Different sources such as FactSet, Bloomberg, Standard & Poor's, and others have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings. We favor Thomson Reuters and FactSet for their long track records and wide followings.

2 DIVERSE CONTRIBUTIONS TO Q2 EARNINGS GAINS

Percent Contributions to S&P 500 Year-over-Year Earnings Growth in Q2 2017



Source: LPL Research, FactSet 08/11/17

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Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

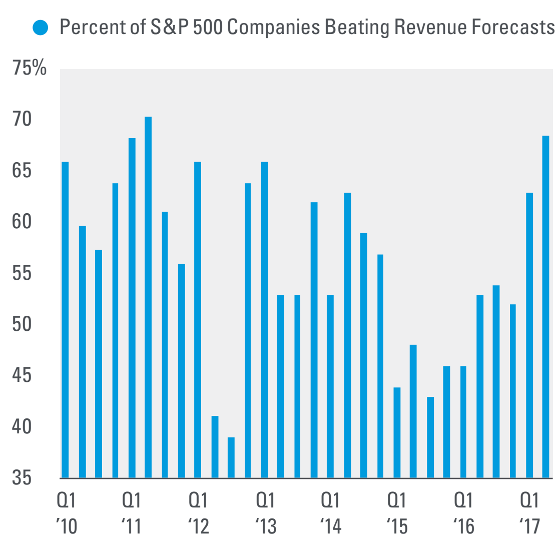
In terms of the drivers of the strong results, an improving global economic growth backdrop, a pickup in business investment, a still easy comparison versus the earnings recession of 2016, and U.S. dollar weakness all played roles (a weaker dollar props up overseas earnings for U.S.-based multinationals). Although the dollar index traded at a higher average price in the second quarter of 2017 than it did in the second quarter of 2016, analysts' estimates generally reflected a stronger dollar than was actually realized in the quarter.

SOLID GUIDANCE

Forward estimates have held up very well since the second quarter ended, indicating guidance has generally been upbeat. Between June 30 and August 11, 2017, estimates for the next four quarters fell by 0.6%, which is less than the typical 2–3% drop observed during prior earnings seasons.

We can also assess guidance by looking at the ratio of negative to positive pre-announcements.

3 BEST REVENUE BEAT RATE SINCE 2011



Source: LPL Research, Thomson Reuters 08/11/17

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Companies share bad news early more than good news, so the negatives are almost always bigger than the positives. But the 1.5 ratio of negative to positive pre-announcements for the third quarter is about as good as it gets, with the long-term average at 2.8 (post-1995). A trend has emerged, as we saw the same solid 1.5 ratio three months ago when companies were providing guidance for the second quarter.

Generally favorable outlooks from company management teams, coupled with steady economic growth and a weaker U.S. dollar, help paint a solid near-term earnings picture. Combine that with the potential for upside from a reduction in the corporate tax rate and lower tax rate for repatriation of overseas cash (we anticipate both in early 2018), and a bright picture could get even better.

CORPORATE BEIGE BOOK BAROMETER

Later this month we will update our Corporate Beige Book barometer: an analysis of the topics covered in companies' earnings conference calls.

CONCLUSION

Second quarter earnings season has been outstanding. S&P 500 earnings rose by double-digits for the second straight quarter with solid upside to both earnings and revenue. The breadth of earnings contributions across sectors was impressive. Company outlooks have been upbeat, buoyed by a weaker U.S. dollar. Strong earnings continue to provide support for the stock market at elevated valuations, with the potential for more support from a reduced corporate tax rate next spring. We believe near double-digit earnings growth is achievable this year (consensus expectations are roughly +10%) and potentially in 2018 as well.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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